Attachment A

Chapter III. Status of the Texas Telecommunications Industry

In June 2000, Southwestern Bell Telephone (SWBT) was granted approval by the Federal Communications Commission (FCC) to enter the long-distance market in Texas. As determined by the Commission and the FCC during SWBT's Section 271 approval process, SWBT had met the statutory requirements to open its local markets to competition.[1] SWBT entered the long-distance market in July 2000. Two years later, Southwestern Bell Corporation (SBC) has made significant progress in the long-distance market while competition in the local market is still emerging, and many competitors of SWBT are struggling to remain financially viable. As competition in the telecommunications market continues to take hold in Texas, several issues and matters have been brought to the forefront for the Commission's consideration.

Chapter III examines competitive issues relating to the local service market in Texas. The discussion begins with an assessment of the data regarding the overall industry revenue and market share for incumbent local exchange carriers (ILECs) and competitive local exchange carriers (CLECs) in Texas. The discussion then turns to how ILECs and CLECs compete in the marketplace. This analysis includes a discussion of the CLECs' methods of entry and geographic market.

Additionally, the Chapter examines competitive issues relating to the long-distance market, including the disparity between intrastate and interstate access rates and the pass-through of access rate reductions by long-distance carriers. The Chapter ends with a look at competitive issues relating to broadband.

A. Local Telephone Market in Texas

1. Texas CLEC Certifications

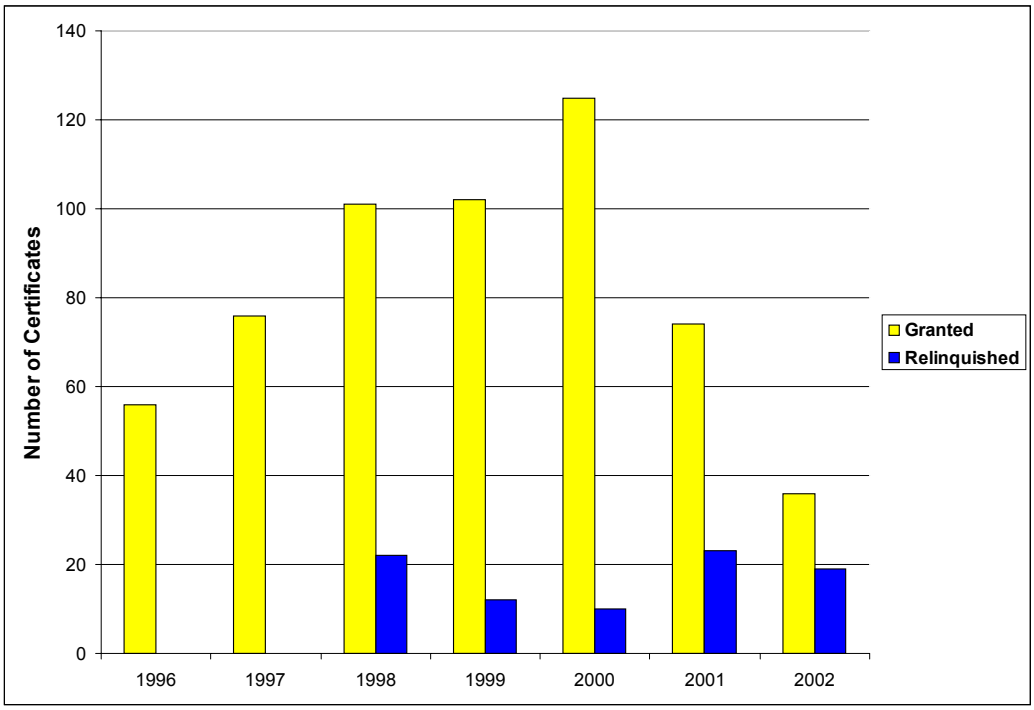
From the passage of the FTA until 1999, Texas saw a huge influx of CLECs seeking to serve markets throughout the State. Under the Public Utility Regulatory Act (PURA) § 54.001, a CLEC must have a certificate issued by the Commission to operate and provide telecommunications service in Texas.[2] As illustrated by Figure 5, the number of service provider certificates of operating authority (SPCOAs) and certificates of operating authority (COAs) applied for and granted annually has declined steadily since 2000. For the year 2001, the Commission awarded 73 SPCOAs and 1 COA; and as of October 23, 2002, the Commission had awarded 34 SPCOAs and 2 COAs. This

[1] *Application by SBC Communications Inc, Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Texas*, CC Docket 00-65, Memorandum Opinion and Order, at 395 (rel. June 30, 2000).

[2] PURA § 54.001 (Vernon 1998 & Supp. 2003).

represents a noticeable decline from the year 2000 when 106 SPCOAs and 6 COAs were awarded. In addition, the number of SPCOAs and COAs relinquished by CLECs has increased from 10 in 2000 to 23 and 19 in 2001 and 2002, respectively.

Figure 1 — Number of SPCOAs and COAs Certifications Granted and Relinquished in Texas, by Year



SOURCE: PUC filings

As shown in Table 3, there are 490 CLECs certified to operate in Texas. Of the 554 certificated telecommunications utilities in Texas, 202 submitted data responses to this year's scope of competition data request, 138 of them CLECs, compared to 128 CLECs in 2000.[3] In addition, 76 CLECs filed letters stating that they did not provide services in Texas during the requested time period.[4]

Table 1 — Number of Texas CLECs

	1996	1998	2000	2002
Approx. Number of Certificated CLECs	70	200	432	490
Approx. Number of CLECs filing Data Responses	n/a	50	128	138

SOURCES: *Report to the Seventy-Fifth Legislature on the Scope of Competition in Telecommunications Markets* at 2 (January 1997), *Report to the Seventy-Sixth Legislature on the Scope of Competition in Telecommunications Markets* at 55, 92 (January 1999), *Report to the Seventy-Seventh Legislature on the Scope of Competition in Telecommunications Markets* at 37 (January 2001); Texas PUC 2003 Scope of Competition Data Responses.

This decline in the number of CLECs in Texas is consistent with trends at the national level. The number of CLECs in Texas declaring bankruptcy and discontinuing services has steadily increased; between 1999 and 2002, 47 CLECs declared bankruptcy. Seven of those went into Chapter 7 bankruptcy, which resulted in the liquidation of the company's assets. A complete list of all carriers with operations in Texas that have filed for bankruptcy is available in Appendix G.

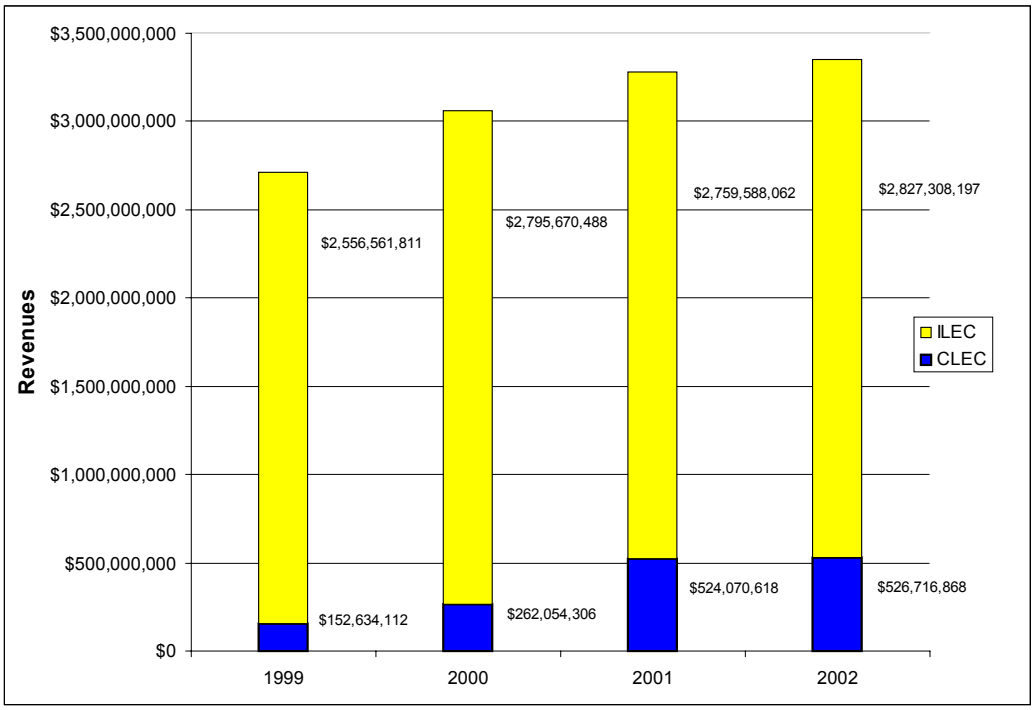
[3] The data compiled for this year's scope report includes self-reported data from 202 ILECs and CLECs. The Commission estimates that this represents at least 95% of the access lines served in Texas.

[4] It is important to note that the number of SPCOAs and COAs overstates the actual number of entrants into the market. While the Commission has certified many carriers to provide service, some have yet to offer any service to the public. A carrier who does not have any customers to date is only a potential competitor. In addition, some carriers with certificates no longer provide service.

2. Overall Industry Revenues and Market Share

After three years of rapid growth, CLEC revenues and access lines ceased to grow in 2002. As shown in Figure 6, CLEC revenues from basic dial-tone service in Texas have also flattened out to approximately $527 million in June 2002, compared to $2.8 billion for the ILECs.

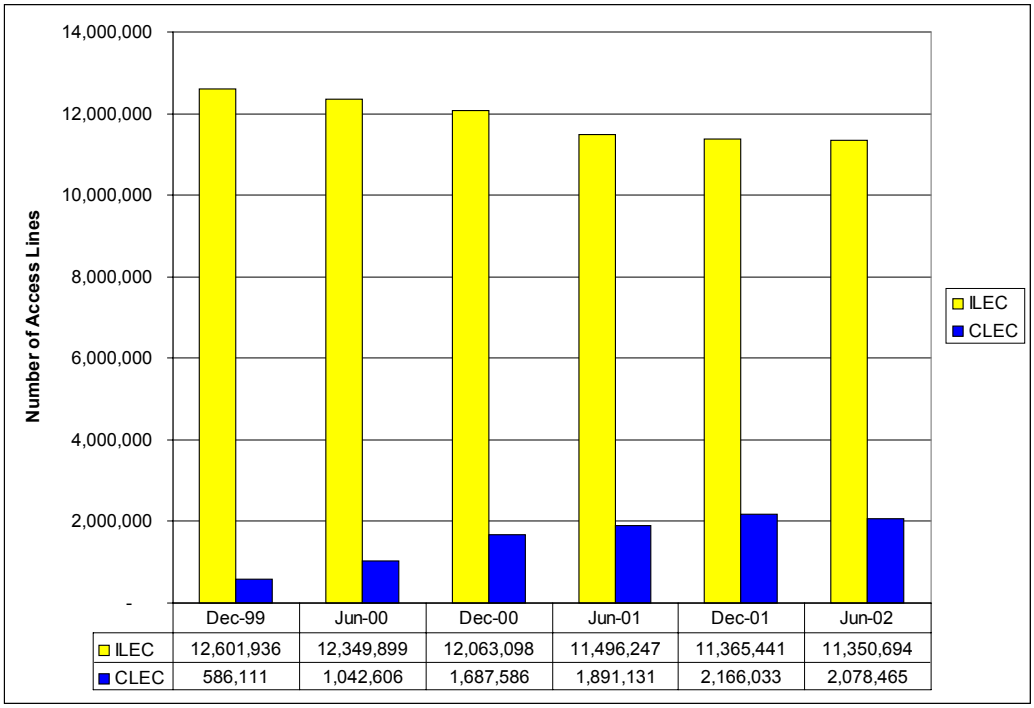
Figure 2 — ILEC vs. CLEC Basic Local Service Revenues in Texas



SOURCE: Texas PUC 2003 Scope of Competition Data Responses. The June 2002 revenue as reported has been doubled to estimate year-end 2002 revenues.

From December 2001 to June 2002, the number of ILEC lines decreased from 11,365,441 to 11,350,694, while the total number of CLEC lines decreased from 2,166,033 to 2,078,465 during that same period.[5] This represents a decrease of CLEC market share from 16% to 15% during that same period and a corresponding increase in ILEC market share from 84% to 85%, despite the overall decrease in ILEC lines.

Figure 3 — ILEC vs. CLEC Lines in Texas



	Dec-99	Jun-00	Dec-00	Jun-01	Dec-01	Jun-02
ILEC	12,601,936	12,349,899	12,063,098	11,496,247	11,365,441	11,350,694
CLEC	586,111	1,042,606	1,687,586	1,891,131	2,166,033	2,078,465

SOURCES: *Local Telephone Competition Reports,* FCC (Aug. 2000, May 2001, July 2002), Texas PUC 2003 Scope of Competition Data Responses.

The rate of overall CLEC market-share growth, which measures the momentum of competitors in the local exchange market, has shown a sharp downward trend over the last two-year period.

Table 2 — CLEC Market Share and Growth Rates in Texas

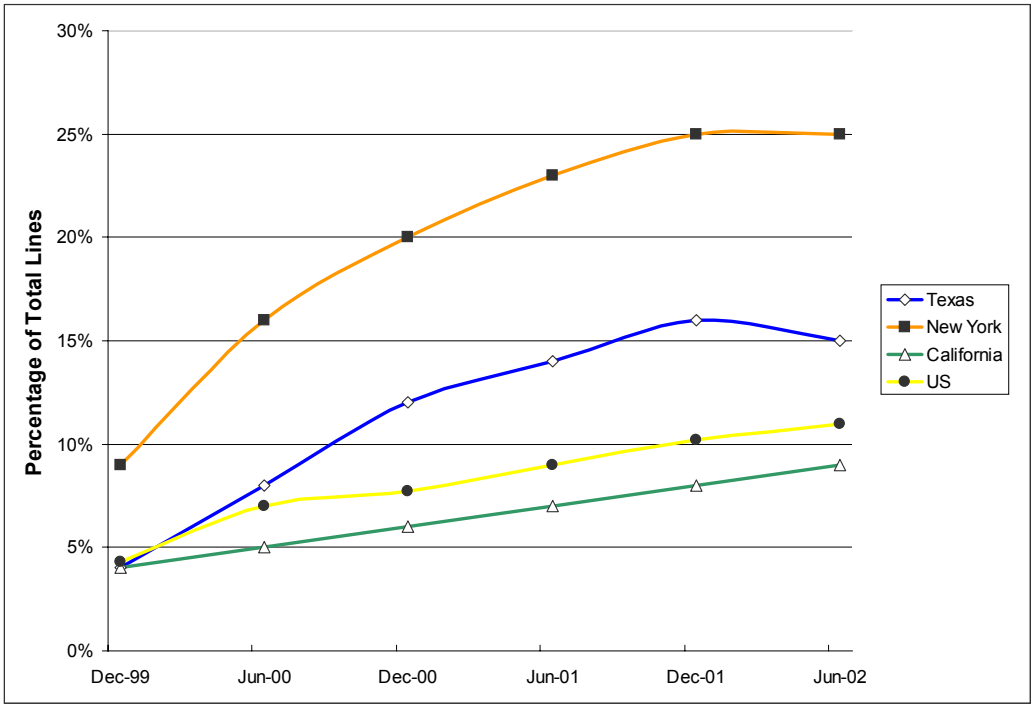
	Dec. 1999	June 2000	Dec. 2000	June 2001	Dec. 2001	June 2002
Market Share	4%	8%	12%	14%	16%	15%
Growth Rate	—	75%	58%	15%	13%	-3%

SOURCES: *Local Telephone Competition Reports*, FCC (Aug. 2000, May 2001, July 2002), Texas PUC 2003 Scope of Competition Data Responses.

[5] For additional data regarding ILEC and CLEC Retail lines in Texas from December 1999 to June 2002, please see Appendix H.

To put the data in a national context, CLEC line growth in Texas (approximately 15% at the end of June 2002) was higher than both the national average (approximately 11%) and the CLEC share in California (approximately 9%). As shown in Figure 8, CLECs in New York, the first state to gain Section 271 approval in 1999, had 25% of the lines.

Figure 4 — CLEC Line Growth in Texas Compared with Nationwide and Other States



SOURCES: *Local Telephone Competition Reports,* FCC (Aug. 2000, May 2001, July 2002, Dec. 2002), Texas PUC 2003 Scope of Competition Data Responses. The FCC reported 2,170,914 CLEC access lines in Texas as of June 2002, which is 92,449 more lines than CLECs reported to the Texas PUC for the same reporting period.

3. CLEC Business Strategies

a. CLEC Modes of Entry

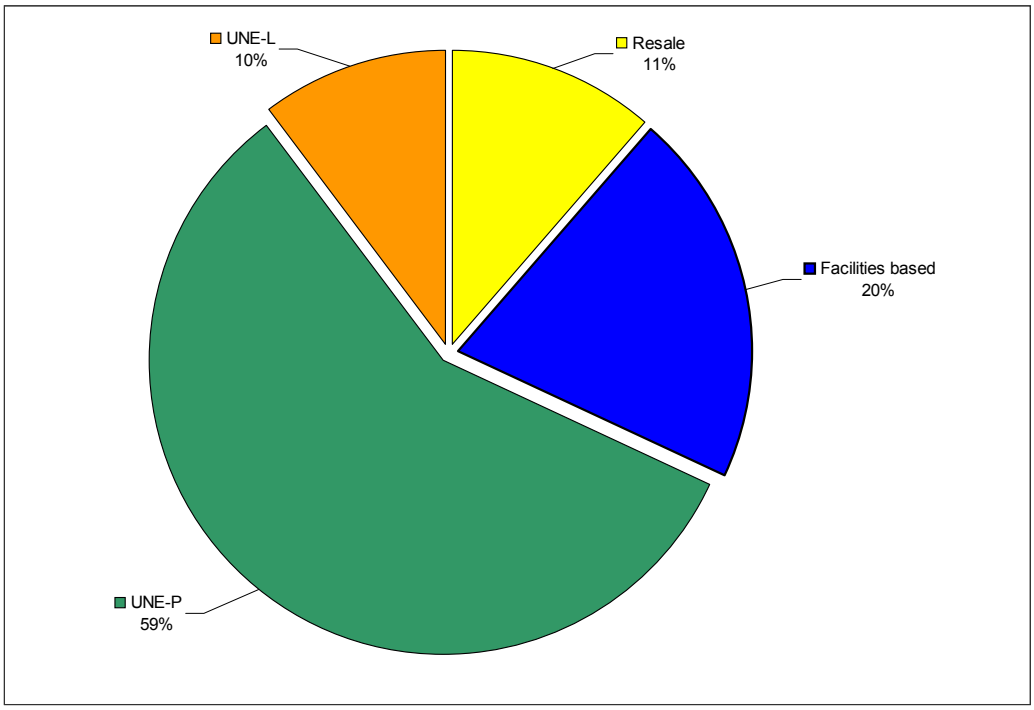
As explained in Chapter II of this Report, Section 251 of the Federal Telecommunications Act (FTA) envisioned three basic modes of entry by CLECs: [6] (1) facilities-based; (2) unbundled network elements (UNEs);[7] and (3) resale.

[6] Please see Appendix I for a detailed explanation of CLEC entry strategies.

[7] The leasing of UNEs typically occurs in one of two fashions, via UNEs (also known as UNE-Loop or UNE-L, which is the lease of one or more of the network components required for the provision of a telecommunications service), or UNE-Platform (UNE-P, which is the lease of a complete set of network elements that allows the provision of an end-to-end circuit). Individual or combinations of UNEs are available pursuant to the parties' relevant interconnection agreement, such as the Texas 271 Agreements (T2A).

As illustrated by Figure 9, Texas CLECs serve customers primarily through unbundled network element platform (UNE-P). As noted earlier, many incumbents are attempting to restrict or limit the CLECs' ability to provide service to end-use customers through UNE-P by seeking changes at the federal level. Because Texas CLECs rely heavily on the use of UNE-P as an entry mechanism, such a decision could have a widespread effect on the competitive market for local telecommunications services in Texas. As is also shown in Figure 9, CLECs serve 30% of their customers using some or all of their own facilities. This includes CLEC-owned and unbundled network element loop (UNE-L) entry strategies.

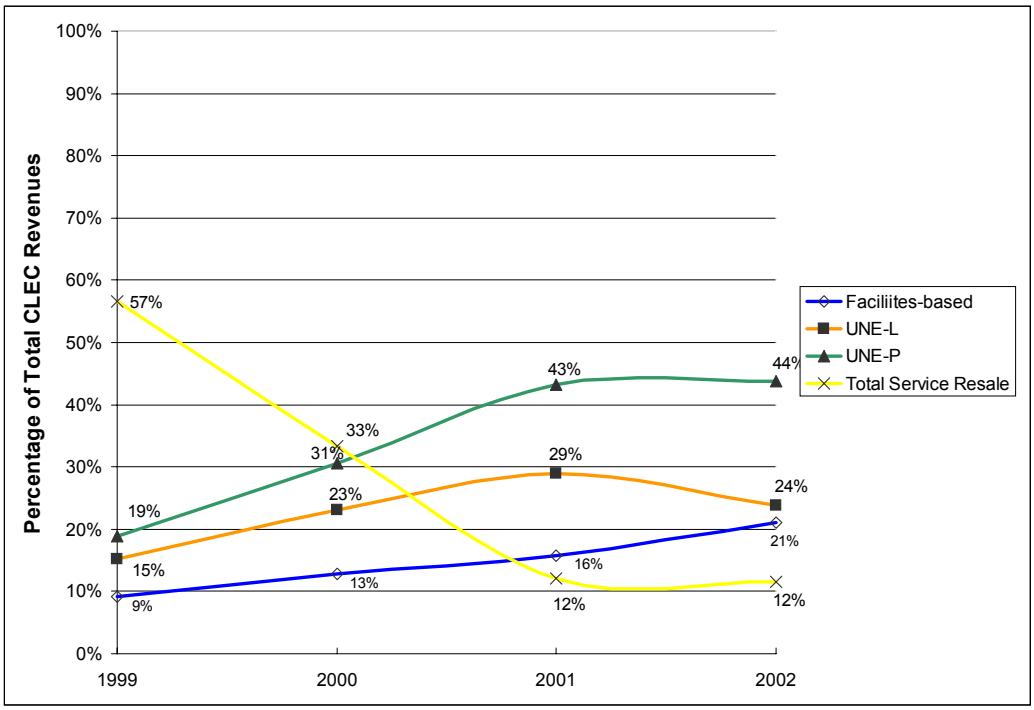
Figure 5 — CLEC Lines by Entry Strategy in Texas, as of June 2002



SOURCE: Texas PUC 2003 Scope of Competition Data Responses

Revenues from total service resale (TSR) have sharply dropped since 1999, and seem to have bottomed out. Revenues reported from the use of unbundled network elements (UNEs) in combination with the CLEC's own switch (known as UNE-L) have also recently shown a downward trend. In contrast, revenues from providing service entirely through the CLEC's own facilities (facilities-based) have steadily increased in the past six months. CLECs using the UNE-P reported revenues that almost doubled between 2000 and 2001, and have since flattened out.

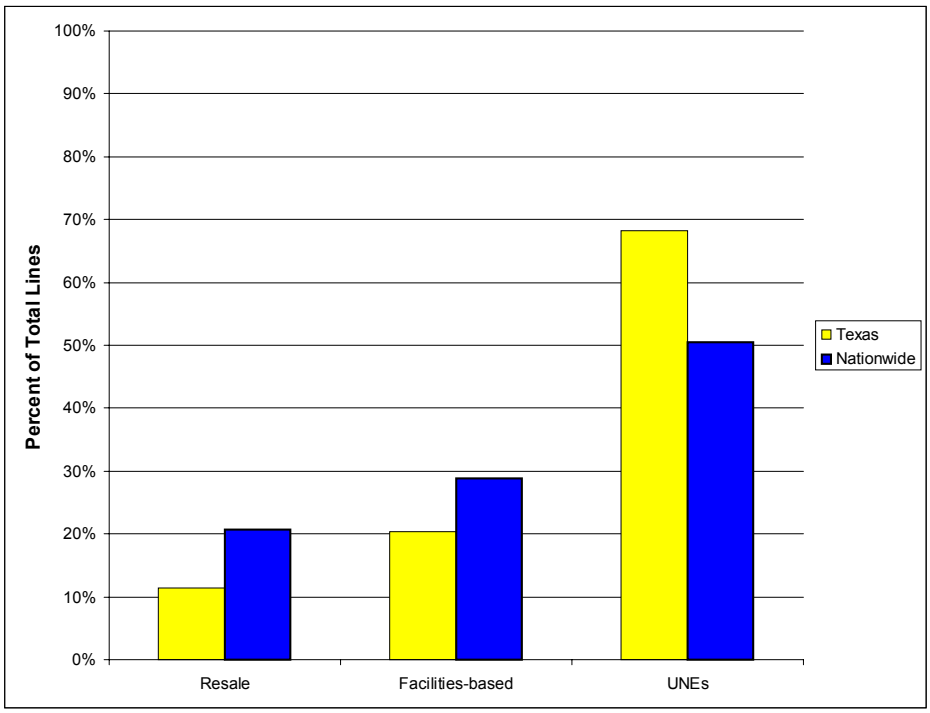
Figure 6 — Revenue by CLEC Entry Strategy in Texas



SOURCE: Texas PUC 2003 Scope of Competition Data Responses. The June 2002 revenue as reported has been doubled to estimate year-end 2002 revenues.

As reflected in Figure 11, the CLECs in the Texas market rely on UNEs more than CLECs in other States. Texas is second only to New York in the number of lines served via UNEs.

Figure 7 — Texas CLEC Entry Strategy vs. Nationwide



SOURCE: June 2002 national data reported in *Local Telephone Competition Reports,* FCC (Dec. 2002), compared with June 2002 Texas data from the Texas PUC 2003 Scope of Competition Data Responses.

b. CLEC Geographic Markets

Overall, CLECs serve Texas customers in all areas of the State, although CLECs serve more customers in urban than in rural areas in absolute terms.

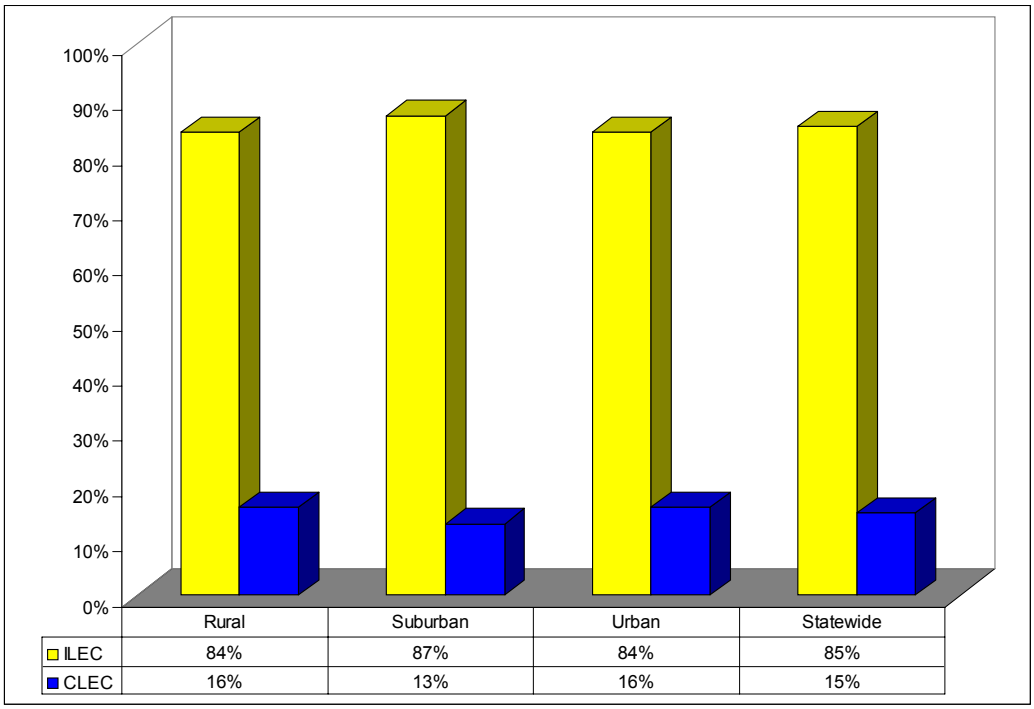
Table 3 — Total Access Lines by Geography

	Rural	Suburban	Urban	Total
ILEC	2,918,097	2,287,050	6,145,547	11,350,694
CLEC	564,413	330,484	1,182,759	2,077,656
Total	3,482,510	2,617,534	7,328,306	13,429,159

SOURCE: Texas PUC 2003 Scope of Competition Data Responses. The CLEC line total excludes 809 access lines for which exchange information was not provided by the carrier.

On a percentage basis, CLECs now serve the same percentage of the access lines in rural areas as in urban areas, as shown by Figure 12. CLECs actually serve a smaller percentage of the access lines in suburban areas than they do in urban or rural areas.

Figure 8 — ILEC versus CLEC Lines in Texas by Geography as of June 30, 2002



	Rural	Suburban	Urban	Statewide
ILEC	84%	87%	84%	85%
CLEC	16%	13%	16%	15%

SOURCE: Texas PUC 2003 Scope of Competition Data Responses

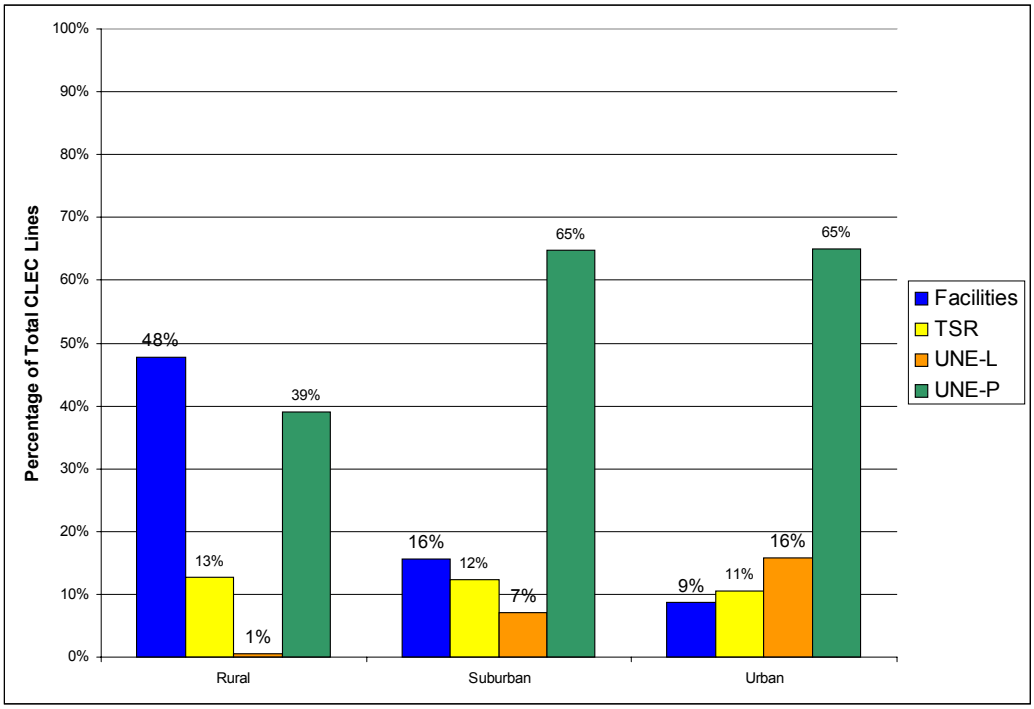
While many CLECs continue to focus their competitive efforts in urban areas, a few niche players have remained strong by serving suburban or rural customers. Sage Telecom, for example, serves rural residential and business customers exclusively through UNE-P, without using any of its own facilities.[8] Using market entry strategies such as UNE-P, UNE-L, TSR, and facility deployment, CLECs have acquired some level of penetration in virtually all areas of the State.[9]

[8] *Petition of MCI Metro Access Transmission Services, LLC, Sage Telecom, Inc., Texas UNE Platform Coalition, McLeod USA Telecommunications Services, Inc. and AT&T Communications of Texas, L.P. for Arbitration with Southwestern Bell Telephone Company Under the Telecommunications Act of 1996*, Docket No. 24542, Direct Testimony of Gary P. Nuttall at 7 (Dec. 7, 2001).

[9] *See* maps contained in Appendices J-M.

As shown in Figure 13, of June 2002, a higher percentage of rural than urban or suburban customers were served by CLECs using the CLEC's own facilities.[10]

Figure 9 — CLEC Lines by Geography and by Entry Strategy in Texas, as of June 2002



SOURCE: Texas PUC 2003 Scope of Competition Data Responses

As shown in Table 6, CLECs serve far fewer lines in suburban areas than in rural or urban, and more than twice as many customers by their own facilities in rural than in urban areas.

Table 4 — CLEC Lines by Entry Strategy and Geography in Texas

	Facilities	TSR	UNE-L	UNE-P	Total
Rural	269,300	71,684	3,036	220,393	564,413
Suburban	51,681	40,877	23,615	214,311	330,484
Urban	102,741	124,401	186,345	769,272	1,182,759

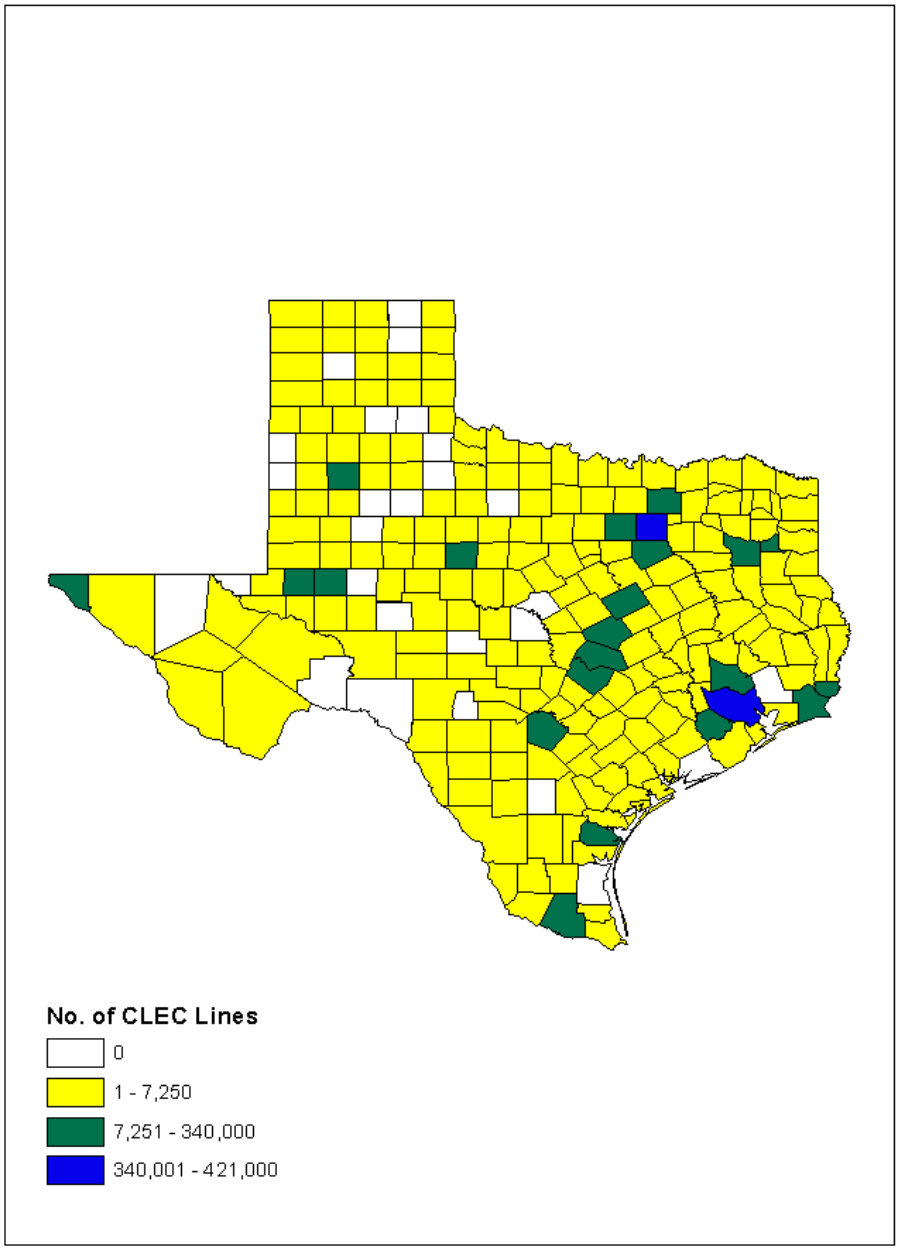
SOURCE: Texas PUC 2003 Scope of Competition Data Responses

As illustrated by Figure 14, CLECs have obtained more lines in urban areas, primarily in downtown and other business districts.[11] This could be attributed to high investment costs and small customer bases in rural areas, resulting in smaller profit margins.

[10] Appendix A, Research Methodology, contains the definition of rural, suburban, and urban that was used to collect data for the 2003 Scope of Competition Report.

[11] *See also* maps contained in Appendices J-M.

Figure 10 — Total Number of CLEC Lines by County, as of June 2002



SOURCE: Texas PUC 2003 Scope of Competition Data Responses

c. CLEC Business and Residential Customers

As of June 2002, CLECs served more residential than business lines in all markets throughout the State. However, it is important to note that the statewide ratio of residential versus non-residential lines is 1.75 to 1, whereas the CLEC ratio is 1.5 residential lines to 1 non-residential line.

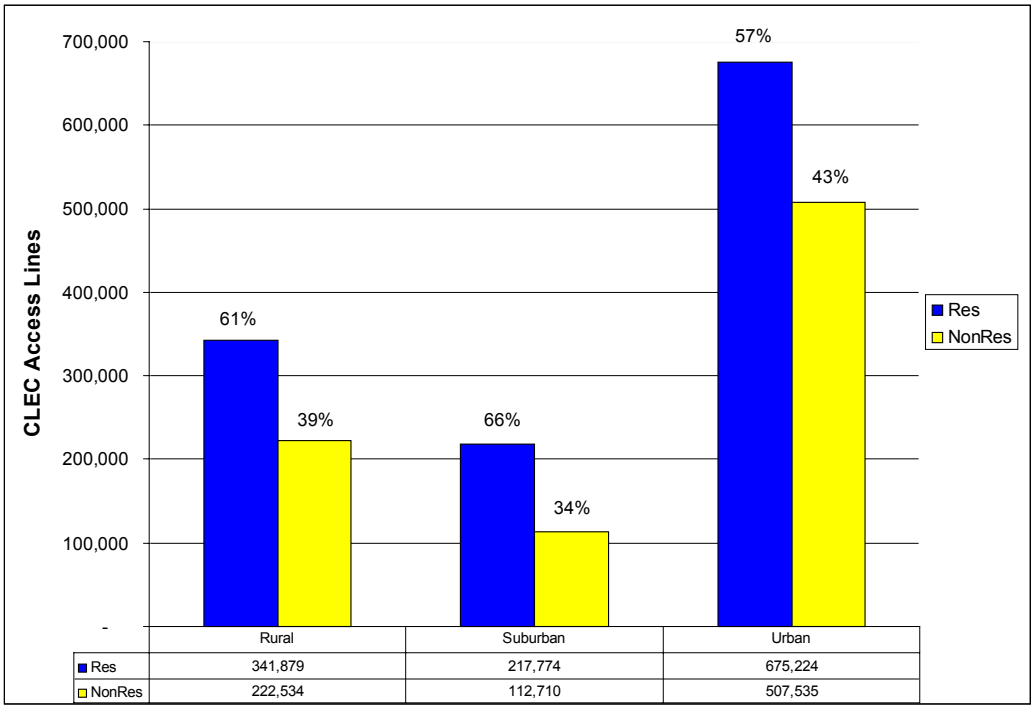
Table 5 — Total ILEC and CLEC Residential and Non-Residential Lines in Texas, as of June 2002

	ILEC	CLEC	TOTAL
Residential	7,319,140	1,235,214	**8,554,354**
Non-Residential	4,031,554	843,251	**4,874,805**

SOURCE: Texas PUC 2003 Scope of Competition Data Responses, excludes ILEC-reported wholesale lines.

A further breakdown of the CLEC residential and non-residential lines in Texas reveals that in all three zones of the State (rural, suburban, and urban),[12] CLECs have more residential lines than non-residential.

Figure 11 — CLEC Lines by Geography and Type of Customer in Texas

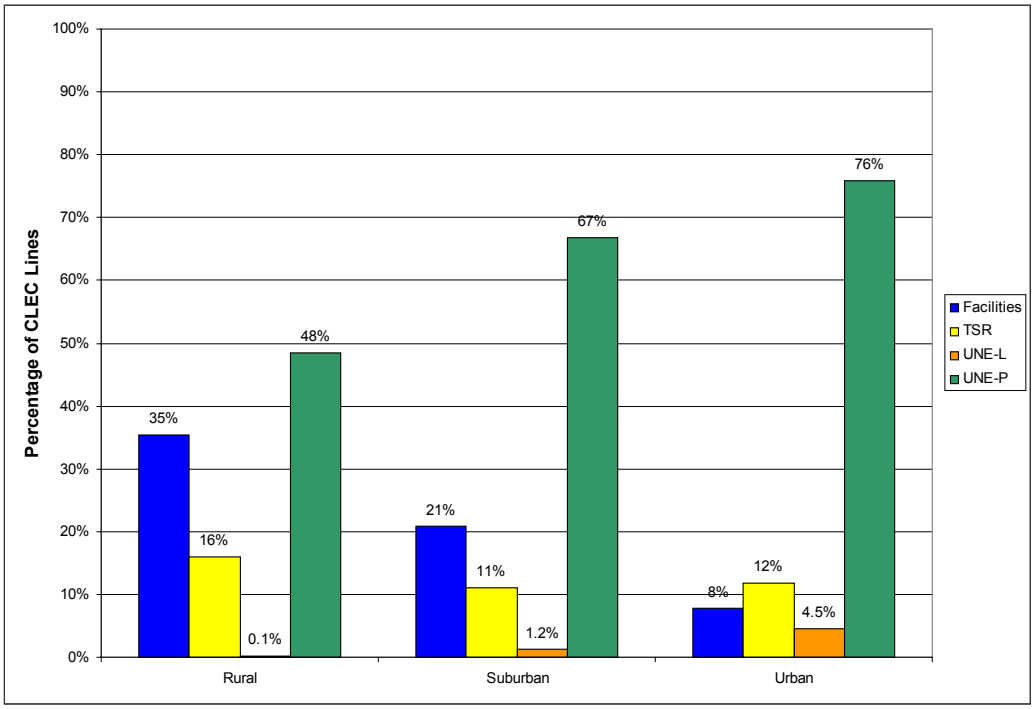


SOURCE: Texas PUC 2003 Scope of Competition Data Responses. Excludes ILEC-reported wholesale lines, and 809 CLEC access lines for which exchange information was not provided.

[12] Appendix A, Research Methodology, contains the definition of rural, suburban, and urban that was used to collect data for the 2003 Scope of Competition Report.

UNE-P remains the entry strategy of choice for CLECs to serve residential customers in any of the three zones.

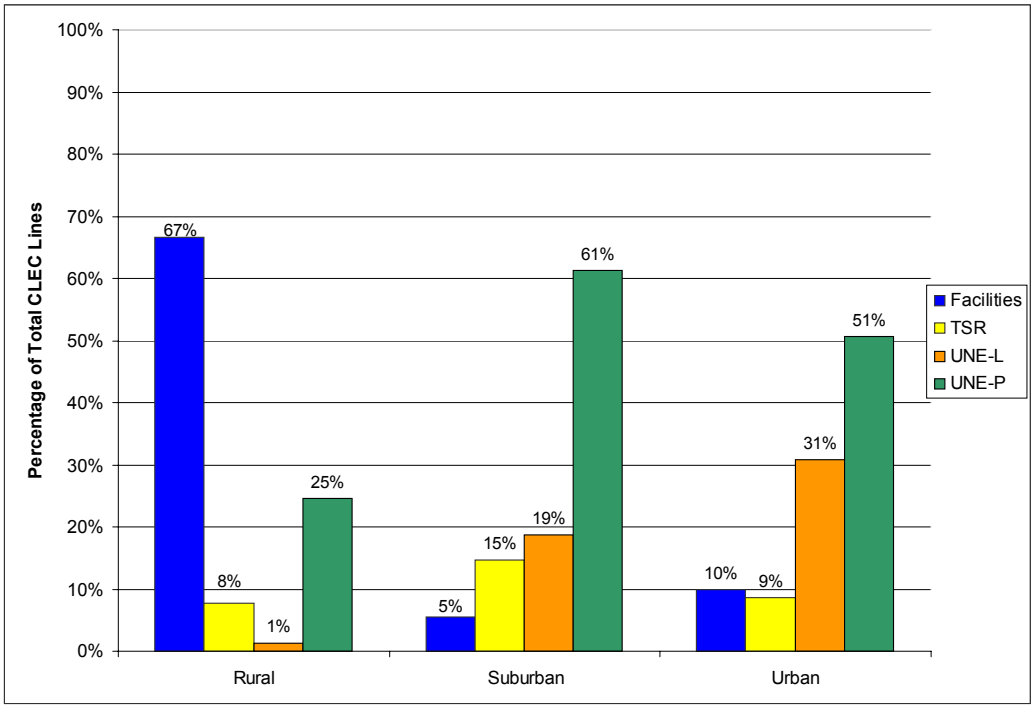
Figure 12 — CLEC Residential Lines by Entry Strategy in Texas



SOURCE: Texas PUC 2003 Scope of Competition Data Responses

However, as shown in Figures 17 and 18, CLECs have made deeper inroads into the non-residential market. CLECs serve three times as many non-residential customers in rural areas (148,190 lines) than in urban areas (49,899 lines) using their own facilities to provide service.

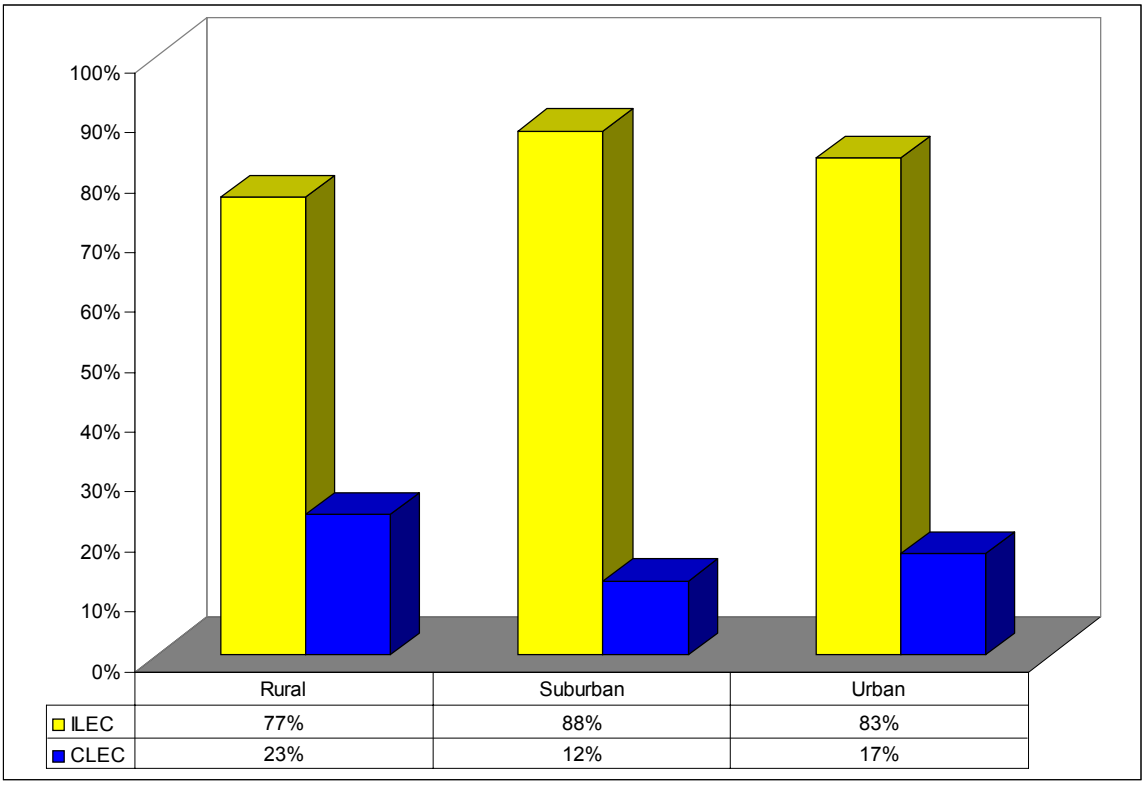
Figure 13 — CLEC Non-Residential Lines by Entry Strategy in Texas



SOURCE: Texas PUC 2003 Scope of Competition Data Responses

In addition, CLECs serve 23% of the business customers in rural areas of the State, compared to 17% market penetration in urban areas, and just 12% in suburban areas.

Figure 14—LEC Non-Residential Lines in Texas by Geography as of June 30, 2002



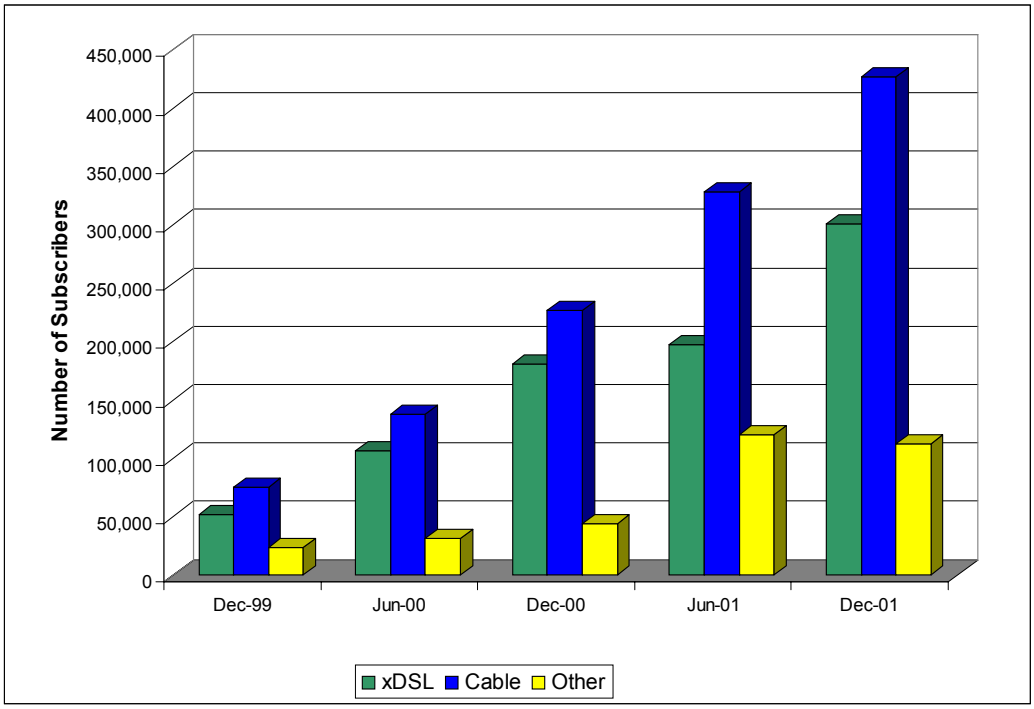
	Rural	Suburban	Urban
ILEC	726,338	796,921	2,495,478
CLEC	222,534	112,710	507,535

SOURCE: Texas PUC Scope of Competition Data Responses. Excludes ILEC-reported wholesale lines, and 809 CLEC access lines for which exchange information was not provided.

B. Broadband Market in Texas

Since the *2001 Scope Report*, broadband subscribership in Texas has grown from 152,000 customers in December 1999 to over one million customers as of June 2002.

Figure 15 — Broadband Subscribers in Texas



SOURCE: *High Speed Services for Internet Access,* FCC (Dec. 2000, August 2001, Feb. and July 2002).

FCC data reveals that of the high-speed lines in Texas, 89% were for residential and small business use; the remaining 11% were lines in service connecting to medium and large business, institutional, or government end-user customers.[13]

With respect to technology deployed in the last mile, 55% of high-speed services were delivered over coaxial cable; 35% were delivered over asymmetric digital subscriber line (ADSL); and 10% included wireline technologies other than asymmetric digital subscriber line (ADSL), optical fiber to the subscriber's premises, satellite, and terrestrial, fixed wireless systems.[14]

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[13] Federal Communications Commission, Industry Analysis and Technology Division, *High-Speed Services for Internet Access, Status as of June 30, 2002*. WIRELINE COMPETITION BUREAU, December 2002. Available online at: www.fcc.gov/wcb/iatd/comp.html.

[14] Federal Communications Commission, Industry Analysis and Technology Division, *High-Speed Services for Internet Access, Status as of July 30, 2002,* WIRELINE COMPETITION BUREAU, December 2002. Available online at: www.fcc.gov/wcb/iatd/comp.html.

With respect to other States, Texas was ranked fourth for the number of high-speed lines. For the period 1999 to 2002, Texas's broadband growth rate exceeded the national average and that of many other large States.[15]

Table 6 — Broadband Subscribers in Texas Compared to Other States

STATE	1999 TOTAL	JUNE 2000 TOTAL	DEC. 2000 TOTAL	JUNE 2001 TOTAL	DEC. 2001 TOTAL	JUNE 2002 TOTAL	% CHANGE 1999 TO 2002
Texas	152,518	267,087	522,538	646,839	840,665	1,050,511	589
California	547,179	910,006	1,386,625	1,705,814	2,041,276	2,598,491	375
Massachusetts	114,116	185,365	289,447	357,256	505,819	583,627	411
New York	186,504	342,743	603,487	893,032	1,199,159	1,460,894	683
North Carolina	57,881	81,998	136,703	205,616	357,906	461,736	698
Pennsylvania	71,926	79,892	176,670	263,236	376,439	516,488	618
Nationwide Total	2,754,286	4,367,434	7,069,874	9,616,341	12,792,812	16,202,540	488

SOURCE: *High Speed Services for Internet Access,* FCC (December 2002).

Broadband providers continue to offer new products and services to attract additional customers. In August 2002, SBC Communications released plans to roll out additional lower-speed, lower-priced digital subscriber line (DSL) options in certain markets in Texas in an attempt to compete with the cable modem market.[16] For example, in a co-branding arrangement with Yahoo, SBC rolled out a slower, less expensive DSL service for $42.95 per month in September 2002.[17]

Cable continues to capture market share, and with the addition of video-on-demand platforms, the cable industry is expected to continue to perform well.[18]

As reflected in Figures 20 and 21 below, in general, there are more broadband providers in counties with higher population densities. However, Figure 21 demonstrates that while several counties in Texas lack cable or DSL providers altogether, a few somewhat sparsely populated counties of the State actually are served by one or more providers.

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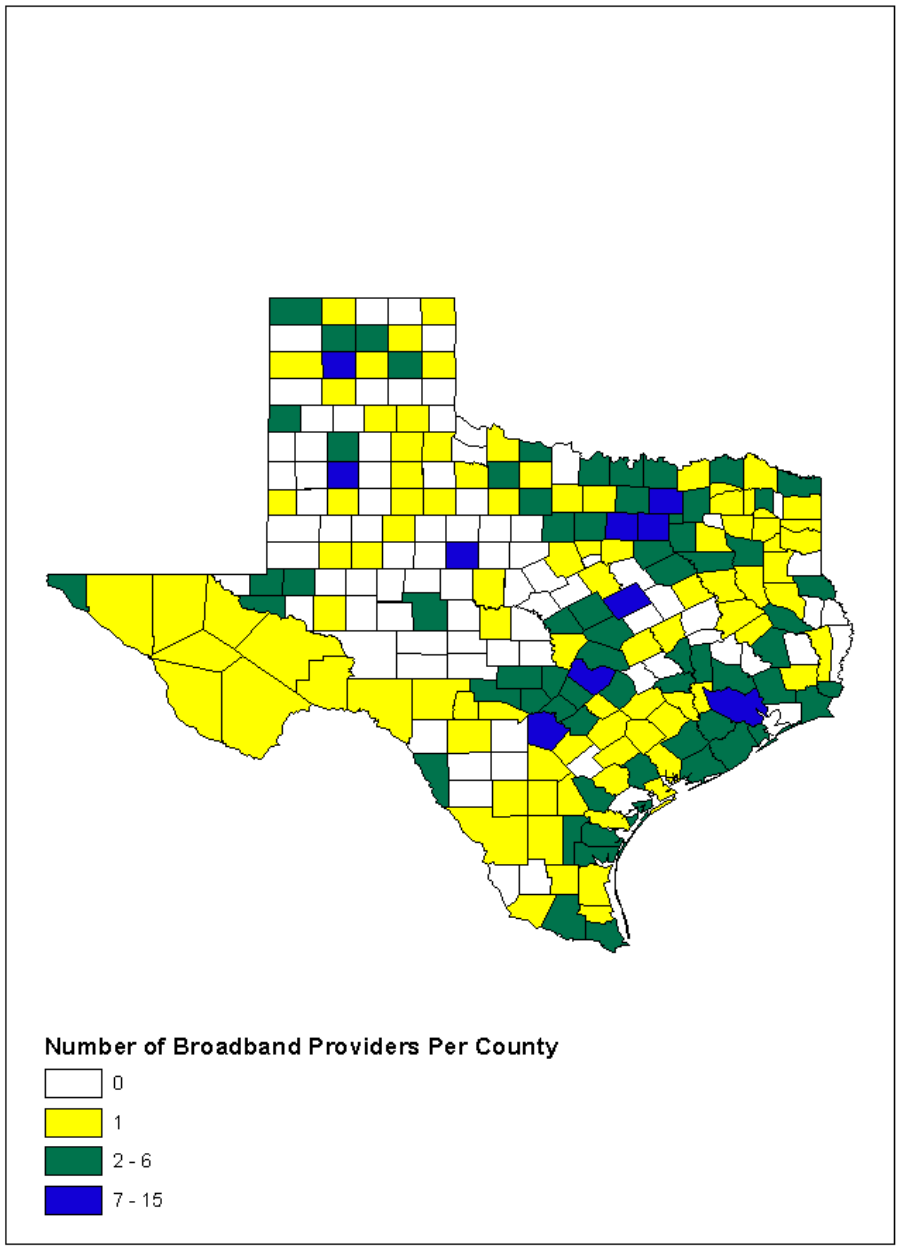
[15] *Id*.

[16] Andrea Ahles, *Quick studies*, FORT WORTH STAR-TELEGRAM, August 22, 2002, p. C1.

[17] Andrea Ahles, *SBC Communications offers co-branded broadband service*, STAR-TELEGRAM at 2C (Sept. 19, 2002).

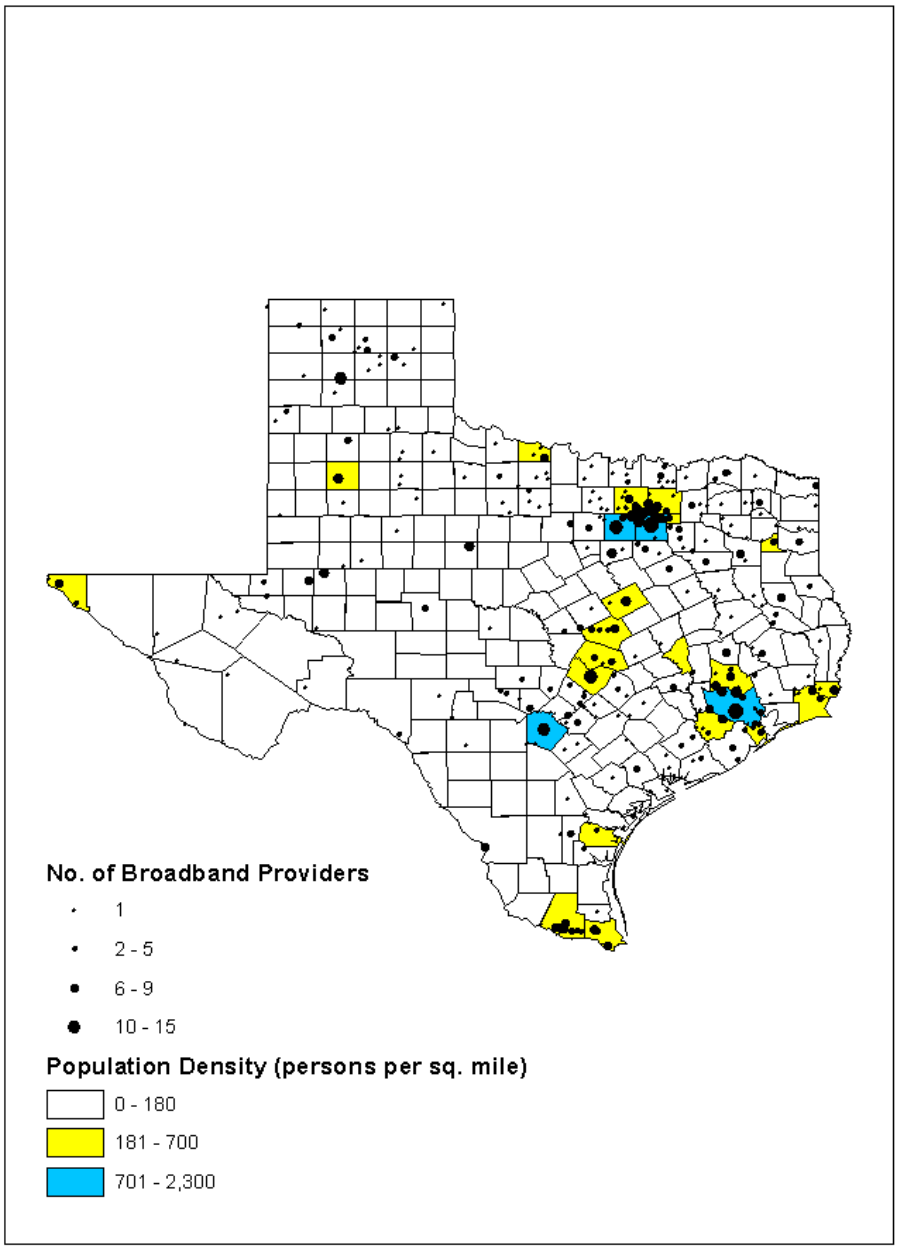
[18] Roben Farzad, *Telecom-Mess Survivors*, FWST (May 5, 2002); Dan Sweeney, *Cable's Plumb Position*, AMERICA'S NETWORK at 32 (July 1, 2002).

Figure 16 — Number of Broadband Providers per County as of June 2002



SOURCE: Texas PUC 2003 Scope of Competition Data Responses

Figure 17 — Number of Broadband Providers by Population Density of County



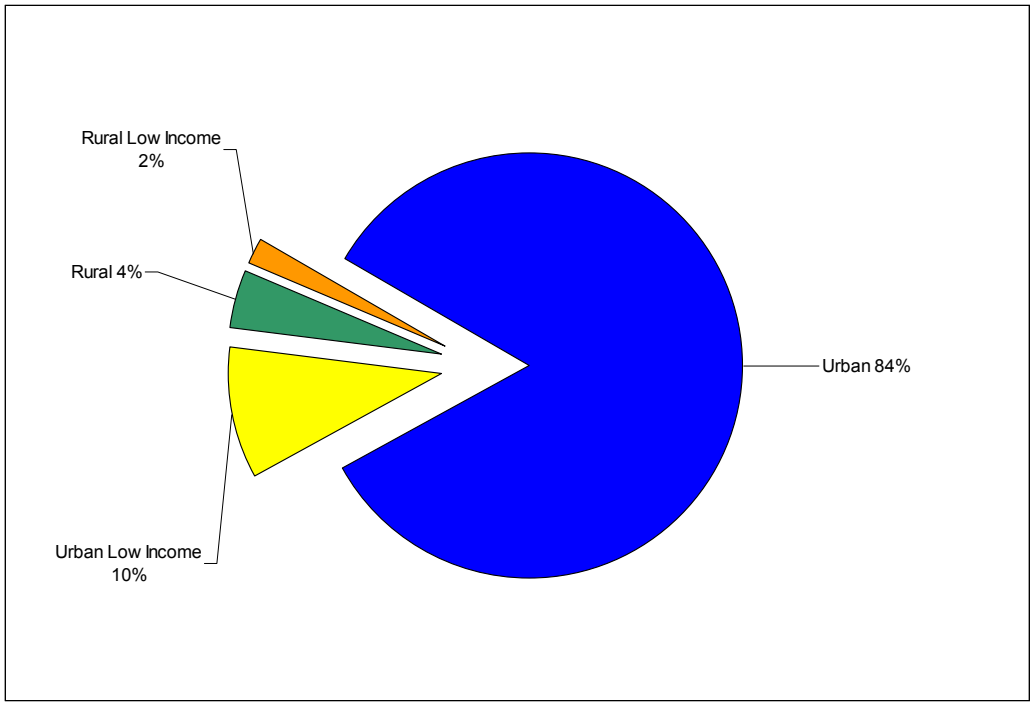
SOURCE: Texas PUC 2003 Scope of Competition Data Responses

Project Pronto

SBC offers a DSL product—referred to as Project Pronto—that it launched in the Fall of 1999.[19] By placing remote terminals further into residential neighborhoods, SBC is able to overcome distance limitations to bring DSL service within the reach of the vast majority of its customers. SBC's goal at the outset was to have DSL available to 80% of its customer base by 2002. By October 2001, SBC had scaled that number back to 58% and was announcing a further slowdown in towns with lower population densities.[20] This slowdown was intended to cut capital expenditures by $1 billion.

As shown in Figure 22, 94% of SBC's DSL deployment in Texas is in urban areas, including low-income urban areas.

Figure 18 — Urban vs. Rural SBC Wire Centers with DSL Deployment, 4th Quarter 2001



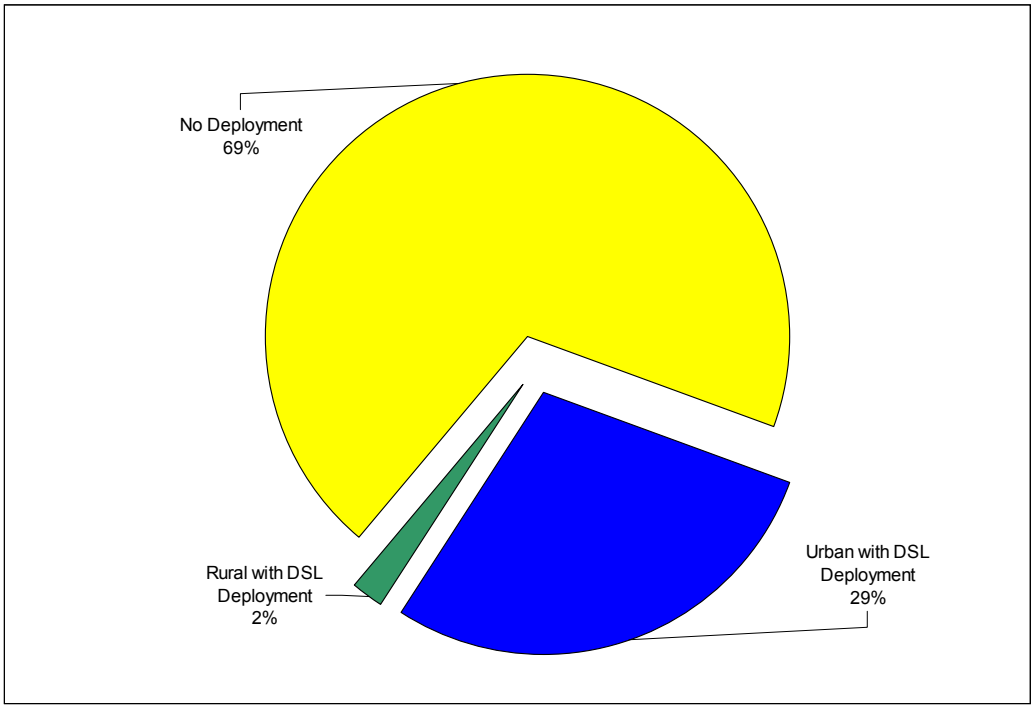
SOURCE: SBC/Ameritech Merger xDSL Deployment,
http://www.fcc.gov/wcb/mcot/SBC_AIT/xDSL_deployment (October 30, 2002)

[19] Karen Brown, *SBC Takes Pronto Out Of DSL Buildout Pace*, BROADBAND WEEK, October 29, 2001.

[20] *Id*.

Figure 23 shows that as of the fourth quarter of 2001, 69% of SBC wire centers in Texas had no deployment of DSL.

Figure 19 — xDSL Deployment in SBC Wire Centers, 4th Quarter 2001



SOURCE: SBC/Ameritech Merger xDSL Deployment,
http://www.fcc.gov/wcb/mcot/SBC_AIT/xDSL_deployment (October 30, 2002)

SBC has argued that while DSL could be one of its key growth enterprises, it is unwilling to invest further substantial capital in it under current regulations.[21] According to SBC, on a nationwide scale, although 70% of high-speed internet access consumers use a cable modem and only 30% use DSL, the cable industry remains virtually unregulated while SBC faces what it calls "pervasive regulation."[22]

[21] Vikas Bajaj, *SBC says industry policies need to change*, DALLAS MORNING NEWS, July 9, 2002, p. D1.

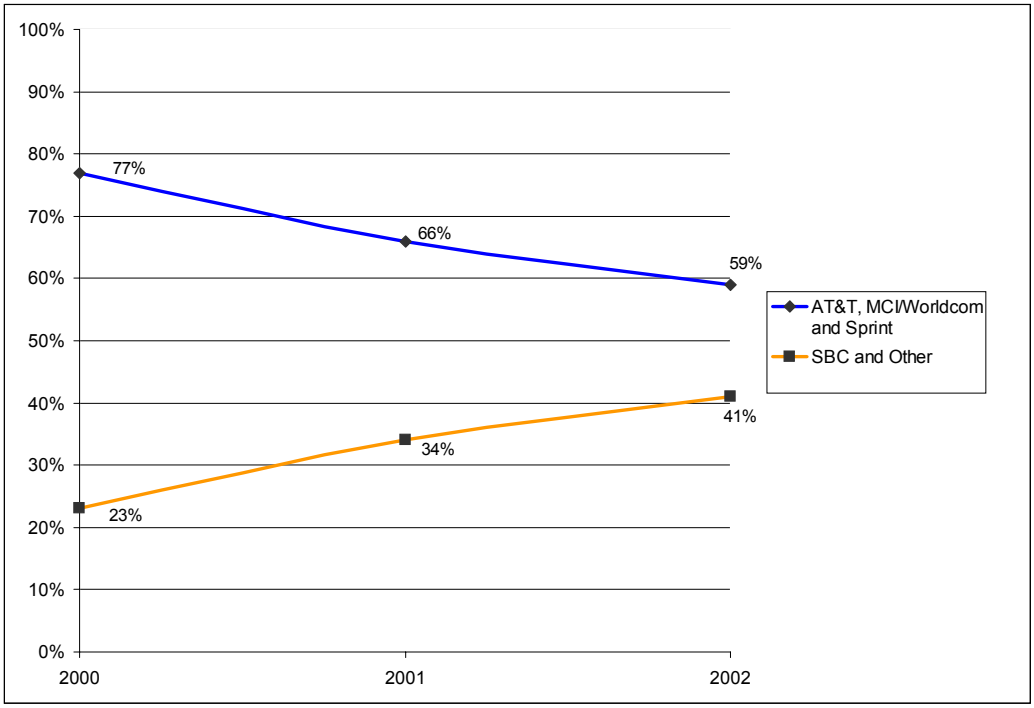
[22] *Id.*

C. Long-Distance Market in Texas

1. Market Share

Since entering the interLATA telephone markets in 2000, SBC's share of the Texas long-distance market has grown. Comparing the long-distance market share (measured in minutes-of-use) jointly held by AT&T, MCI/WorldCom, and Sprint with that of SBC and other carriers, the market share of SBC and others grew from 23% in 2000, to 34% in 2001, and reached 41% in 2002.[23]

Figure 20 — Long-distance Market Share Over Time



SOURCE: Texas PUC 2003 Scope of Competition Data Responses. The other category includes facilities-based IXCs, such as Williams Communications and Broadwing, Inc., as well as resellers.

Increased long-distance competition has resulted in substantial savings for customers. A recent analysis of Texas long-distance rates indicated that Southwestern Bell's entry into the long-distance market lowered peak long-distance prices by 11%, weekday off-peak prices by 18%, and weekend off-peak prices by 9%.[24] The same study found that the average Texas consumer would have paid $17.52 for long-distance prior to SWBT's entry and would have paid $15.72 in the post entry period, implying a savings of $1.80 or 10.3%.

[23] Texas PUC 2003 Scope of Competition Data Request.

[24] Hausman, Leonard, and Sidak, Does Bell Company Entry Into Long Distance Telecommunications Benefit Consumers?, 70 ANTITRUST L.J. (2002) at 463.

2. Long-Distance and Wireless Comparison

As discussed in Chapter II of this Report, the wireless market is growing while the long-distance market seems to be shrinking. Table 9 demonstrates that there is some correlation between the growth in the wireless market and the decline in the long-distance market. This comparison was done by comparing the number of mobile subscribers in Texas, which has nearly doubled in the last two years, with the number of switched access minutes-of-use in Texas, which increased slightly between 1999 and 2000 and has subsequently fallen off by about 3%. Table 9 also includes the number of basic dial tone lines, which expanded in 2000 from 1999 levels, but fell in 2001.

Table 7 — Comparison of Wireline and Wireless in Texas

	1999	2000	2001
Mobile Wireless Subscribers	5,792,453	7,548,537	9,062,064
Long-distance (Switched Access) Minutes of Use	11,397,493,545	11,495,969,512	11,137,023,457
Total Basic Dialtone Lines	13,188,047	13,750,684	13,531,474

SOURCES: *Local Telephone Competition Reports,* FCC (Aug. 2000, May 2001, July 2002), Texas PUC 2003 Scope of Competition Data Responses.